CORPORATE GOVERNANCE IN NEW ZEALAND

Consultation on Issues and Principles

BACKGROUND REFERENCE

To be read in conjunction with the Questionnaire

Securities Commission
September 2003

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Message from Jane Diplock

Chairman, Securities Commission

The Minister of Commerce has asked the Securities Commission to take the lead in developing an agreed set of Corporate Governance principles for New Zealand.

In responding to this request, we are setting out to establish the level of consensus in the New Zealand business community around norms or expected standard of behaviour for Corporate Governance.

Depending on the level of consensus that we find around the broad areas of Corporate Goverance (referred to as issues), principles will be developed which reflect the business community's position.

The focus of this project is not law reform. Neither is this a place to revisit existing law.

This exercise, in itself is not aimed at reducing the rate of corporate failure, nor will it necessarily result in an increase in ethical behaviour. However, a set of principles which New Zealand business supports, will in our view, contribute to better Corporate Governance.

Our approach to this task has been to examine the large amount of work already done on Corporate Governance both in New Zealand and in other countries. There have been many thoughtful and valuable contributions to the Corporate Governance debate. In New Zealand important work has been done by the New Zealand Exchange, the Institute of Chartered Accountants of New Zealand, the Institute of Directors in New Zealand and some professional services firms.

We recognise that not everyone will agree on everything. In fact, there are some areas where there is likely to be considerable disagreement. None the less, from this consultation we expect to develop a set of principles that most can embrace, and which is appropriate for New Zealand.

To grow and prosper, New Zealand businesses must inspire confidence in local and international investors, partners, suppliers and customers. For this to happen, our Corporate Governance must be world-class. We trust that the principles will be adopted by directors as a tool to enhance the confidence in and the standing of their companies.

Corporate Governance policies and practices in New Zealand are, by and large, of a good standard. Good governance is vital not only for public, listed companies but for other forms of business entity as well. We hope that after this consultation the resulting principles will be useful for all types of entity, including cooperatives and state-owned enterprises. Ultimately, good governance should help businesses become more innovative, competitive and financially sustainable.

We urge you to be part of this process by completing the questionnaire and by encouraging others to do so too.

Jane Diplock AO

The New Zealand Approach

There is a wealth of writing on governance in New Zealand and other countries, much of this available on the Internet (see references on pages seven and eight).

This paper defines Corporate Governance in widely accepted terms and briefly summarises some of the key developments from both New Zealand and international sources that should help to inform the development of agreed principles for New Zealand.

There are some features of the New Zealand economy that present special considerations in relation the Corporate Governance debate. While the focus overseas has been primarily on the governance of publicly listed companies, in New Zealand there are a significant number of enterprises that are structured as:

- Subsidiaries of overseas companies, either wholly owned by the overseas parent, or majority owned with the balance being either traded on the New Zealand Exchange, or otherwise held by New Zealand

- Supplier or purchaser owned co-operatives, where the relationship between the shareholder and the company goes beyond the investment relationship typical of a listed company

- Widely held unlisted companies, some of whose shares are traded through informal trading mechanisms or in the so-called "grey market"

- Government and local authority owned entities

- Closely held or family owned companies

- Large Trusts

This paper is accompanied by a questionnaire that has been developed to enable the Securities Commission to identify both the range of principles that might be developed as well as the extent of coverage that these principles could have in relation to different forms of corporate entity.

Continued over

The Consultation Process

The consultation process has been developed to enable the Securities Commission to identify the level of consensus within New Zealand around:

1. What a set of governance principles should encompass

2. The range of issues that need to be reflected in the principles

3. The range of entities to which the governance principles should apply

The Commission has used external advisers to develop the Background Reference Paper and the Questionnaire that underpin the consultation process. Both the Questionnaire and Background Reference paper have been subject to rigorous peer review.

1. The Principles
Based on the review of local and international perspectives and practices, nine core issue areas have been identified (see page six).

Using the feedback obtained through this consultation practices, overarching principles will be crafted in relation to each of the nine issue areas – eg Ethical Conduct, Board Committees, Shareholder Relations etc.

2. The Issues
While there is consensus in some areas about the issues that the governance principles should address, there are also a number of issues around which opinion is divided.

Based on the review of local and international material, a series of propositions has been developed to enable the Securities Commission to gauge the depth and range of opinion around governance practices to establish the norms that the principles should inform.

If the propositions appear to suggest a rules based approach, this is neither the intention of the Commission nor the mandate that the Commission has been given.

The Commission is interested in assessing the extent to which there is consensus around specific issues to inform the development of a set of principles.

3. The Outcomes
The consultation process has been developed to enable the Commission to present the Minister of Commerce with a set of Corporate Governance Principles, around which there is broad based consensus in New Zealand. If there are areas where there is a clear lack of consensus, then these will be acknowledged.

The Securities Commission, in undertaking this exercise, has not been mandated to develop rules or regulations or recommend legislative change or remedies with respect to these Corporate Governance principles.

The Commission is concerned to ensure that the report of findings that is presented to the Minister builds on the considerable body of work that has already been undertaken in New Zealand and that the Principles are broadly aligned with both international and local developments in this area.

The Commission has undertaken to report to the Minister before the end of December.

4. The Next Steps

The consultation process is open to all interested parties.

To enable the Securities Commission to present the findings of this process to the Minister by the end of December, the Commission has set a deadline for submissions of **5pm Friday November 7.**

Submissions should be made using the questionnaire – an electronic version is available on the Securities Commission website (see below). This may be more useful if the replies require more space than provided in the printed version of the questionnaire.

The project has been designed for qualitative rather than quantitative analysis. This means that responses will neither be analysed nor tabulated in percentage terms, but considered in relation to the level of agreement around the key issues or themes that the findings suggest. Please note that the comments provided in the questionnaire will not be attributed to individuals or organisations.

A set of principles will be drafted based on the response to the questionnaire. If you are interested in being kept informed about the process, please tick the appropriate box in the questionnaire and make sure that you provide your email and/or postal details.

Additional copies of the Background Reference Paper and Questionnaire are available on the Securities Commission website – www.sec-com.govt.nz

Thank you for your assistance.

The Key Corporate Governance Issues

Corporate Governance is the set of structures and behaviours by which a company or other business entity is directed and managed. The structures and behaviours guide how the entity sets objectives, develops strategies and business plans, monitors and reports on performance, and manages risks. They also guide how directors and managers meet all expectations and that they be responsible and accountable in their respective roles.

There is no single model of good governance: the particular structures and behaviours that are best for one entity will depend on factors including its form, size and type, and its stage of development. But with any good Corporate Governance, there is an emphasis on ethical conduct, transparency, legal compliance and sound business practice.

The key issues in Corporate Governance are varied and complex.

This paper sets out background information to nine issue areas that have been identified as platforms for good governance.

The issues are:

1. **Ethical Conduct** – including the use of codes of ethics

2. **Board Composition and Performance** – including the role and definition of independent directors and the issues of certification/accreditation

3. **Board Committees** – including composition of committees

4. **Reporting and Disclosure** – including quarterly reporting and certification of financial Statements

5. **Remuneration** – of executives and directors

6. **Risk Management** – including levels of disclosure

7. **Auditors** – including rotation and oversight

8. **Shareholder Relations** – including institutional shareholders, public reporting

9. **Stakeholder Interests** – addressing the interests of stakeholders

International Developments

Regulators around the world seek to promote good governance through either a "rules-based" or "principles-based" approach. The former tends to rely more on detailed prescription while the latter sets guidelines for behaviour with detailed disclosure thereafter.

The United States has taken the rules-based approach. The Congress passed the Public Company Accounting and Investor Protection Act 2002 or Sarbanes Oxley Act, in response to US debate following major corporate collapses. The Sarbanes Oxley Act imposes extensive requirements on public companies, issuers, and auditors in respect of financial reporting and auditing, disclosure and other governance practices: see www.sarbanes-oxley.com or for summary information, www.aicpa.org

Other countries have tended to have a more principles-based approach.

The United Kingdom has a history of debate and review on governance matters, much of this embodied in "The Combined Code: Principles of Good Governance and Code of Best Practice" for companies listed on the London Stock Exchange (UK Code). An updated Code takes effect on 1 November 2003 after revisions by the Financial Reporting Council (FRC): see www.frc.org.uk

This follows a government-initiated "Independent Review of Non-executive Directors" by Derek Higgs (Higgs Report, January 2003): see www.dti.gov.uk

The revisions also embody recommendations in the FRC-commissioned Smith Report (January 2003) on the role and practices of audit committees. The earlier Hampel, Cadbury, Greenbury, and Turnbull reports examine various governance issues of international relevance.

Australia has been very active on matters of Corporate Governance policy, largely through the Federal Government's Corporate Law Economic Reform Program. The so-called CLERP 9 package (September 2002) outlines legislative and other changes in audit regulation, financial reporting and disclosure, and shareholder participation: see www.treasury.gov.au

The Australian Stock Exchange formed a Corporate Governance Council to work on the issues and produce "Principles of Good Corporate Governance and Best Practice Recommendations" (March 2003) (Australian Principles): see www.asx.com.au

International agencies have been active also, including an OECD working group with New Zealand Government participation. OECD Principles of Corporate Governance (OECD Principles) are a consensus view on fundamental principles for all member countries: see www.oecd.org

The Commonwealth Association for Corporate Governance published "CACG Guidelines: Principles for Corporate Governance in the Commonwealth" (1999): see www.combinet.net

New Zealand References

Debate in this country has been served by valuable proposals and commentaries over the past year including:

- NZX Corporate Governance Best Practice Code (NZX Code) and proposed listing rule revisions (May 2003): see www.nzx.com
- Institute of Chartered Accountants of New Zealand (ICANZ) "Report for the Minister of Commerce: Improving Corporate Reporting – a Shared Responsibility" (March 2003): see www.icanz.co.nz
- Institute of Directors in New Zealand publications and commentary on best practice for directors and proposals for certification: see www.iod.org.nz
- Commentary from professional service firms, notably an extensive "Corporate Governance White Paper" from Minter Ellison Rudd Watts (July 2002): see www.minterellison.co.nz
- Joseph Healy's "Corporate Governance and wealth creation in New Zealand", published in hard copy by Dunmore Press, 2003
- Securities Commission draft principles (November 2002) and speech by Jane Diplock, (April 2003): see www.sec-com.govt.nz
- PriceWaterhouseCoopers "Corporate Governance Issues Research" (February 2003) www.pwc.com/nz

Issue One: Ethical Conduct

Good governance will always require ethical and responsible conduct by directors and managers. Ethics, it is sometimes said, cannot be regulated. Much thinking has been devoted to what particular structures and guidelines might have a positive influence on behaviour and so promote ethical conduct among directors and managers.

Formal codes of **ethics or conduct** are widely favoured: companies adopt codes as a set of behavioural guidelines and to demonstrate for shareholders, and others, their commitment to ethical conduct. The Australian Principles, for example, recommend each entity form its own Code of Conduct that will bind directors and those employees who “materially influence the integrity, strategy and operations of the business”. NZX proposals would apply the same approach in New Zealand. The Sarbanes Oxley Act requires disclosure from US public companies on their codes of ethics for senior management (or explanation as to why they not have such codes).

Codes may contain many **different elements**, including some that are specific to the type of entity. Conflicts of interest – how to identify and manage them – is one area of focus. Trading in company shares is another: the Australian Principles recommend public companies form their own policies and procedures to ensure compliance with laws on insider trading.

Where codes have been adopted, it is often not clear what happens if and when they are breached. The Australian Principles outline that individual directors and employees have responsibilities to report and investigate apparent **code breaches**. There are questions also over the value of **disclosing codes** and perhaps reporting on performance against them. There are a range of views on the effectiveness of codes.

Refer Questionnaire page 5

Issue Two: Board Composition and Performance

Boards must be effective in performing crucial supervisory and monitoring roles in their own particular context. Much has been written on the Corporate Governance role of boards. An international view on the nature and extent of their responsibilities is, for instance, well articulated in the OECD Principles.

The structure and culture of boards varies widely around the world. For instance, in Northern Europe it is common for an entity to have two boards, supervisory and management, that have separate but complementary functions. In the USA, Board power has often been concentrated around the role of the Chairman/CEO. Board effectiveness will always involve issues of board composition and performance self-assessment.

It is widely accepted that boards must comprise directors who can think independently and objectively, and effectively hold management to account. The role of **independent directors** is important. The Australian Principles, the Sarbanes Oxley Act and the new UK Combined Code all favour boards having a majority of independent directors (exceptions for smaller listed companies in the UK): they have broadly similar definitions of independence (the Higgs Report gives a comprehensive definition).

NZX proposals favour independent directors comprising at least one third of the board (with a minimum of two directors). A key difference is that under the NZX rules the minimum 1/3 requirement would be compulsory, whereas the ASX approach is to propose the principle of a majority of independent directors and require explanation if it is not followed.

There is ongoing debate on how to reconcile the role of independent directors with the boardroom interests of majority shareholders, and the limitations of any one definition of "independence". There is a view that the focus should really be on boards comprising of the best directors, with "best" encompassing individuals' abilities to think independently and objectively regardless of their other interests (business, social or personal).

There is now wide agreement that a single person should not be both an entity's **chairperson and chief executive**. The Australian Principles, Sarbanes Oxley Act and UK Combined Code all take this view. Merging of the roles, it is argued, upsets the proper balance that should exist between board and management: objectivity will be diminished on the board.

There is also a view that the chief executive should not go on to subsequently become the chairperson of a board. The UK Code goes further by promoting the role of a senior independent director who can be approached by shareholders as an alternative to the chairman or chief executive. Another question arises over the importance or otherwise of having the chief executive as an executive director. In one view, this should be the case to ensure the necessary flow of information between board and management, and facilitate "team work" which some commentators see as crucial among the individuals who guide and manage any business.

Continued over

Defining optimum **board size** is inherently difficult. Some poorly performing US companies have been criticised for having relatively large boards. There is a general view that the "right" size for any entity will depend on the size and nature of its business, and its stage of development. The Australian Principles see the question being naturally resolved through a focus on ensuring boards have the range of competencies they need to be effective. Some academic literature has argued that a group of seven to nine members is the optimal size for decision making.

There is wide agreement on the value of regular **performance monitoring** at board level, as well as performance monitoring of management. The Australian Principles, for instance, recommend evaluation of the whole board, its committees, individual directors and executives in the context of measures to encourage higher performance (with disclosure on evaluation procedures). The UK Code and current NZX proposals take a similar approach with regular evaluation extending to individual directors. Performance assessments are clearly of interest to shareholders, this being one purpose for annual meetings. There may be scope to develop channels for shareholder feedback on board performance (assuming that such feedback is fair and constructive).

Board performance will obviously reflect the skills, knowledge and experience of directors. There is ongoing debate on the particular nature of these – and the extent to which boards and shareholders should be satisfied that new recruits do indeed have them. Current NZX proposals place emphasis on this issue, with directors urged to undertake appropriate training and to "remain current". The Institute of Directors of New Zealand has recorded a wide range of views on this issue.

The same issues arise over the most effective processes for director recruitment, bearing in mind that directors require election by shareholders but boards make crucial selection of the nominees. The UK Code calls on entities to have "open and rigorous" procedures around the nomination of directors. The Australian Principles address the issue with recommendations for board nomination committees to have special responsibilities and for induction training for directors once elected. There are questions around the tenure of directors with the UK Higgs report suggesting, for example, a three-year initial term as most appropriate and a maximum of nine years service by any one director. On one hand, directors risk losing independence and objectivity through familiarity with the business and its management: on the other they grow in knowledge and experience.

Refer Questionnaire pages 6-8

Issue Three: Board Committees

It has become common practice for boards to form committees of directors tasked with applying particular focus to areas of board responsibility, most notably auditing and financial reporting. There is a common presumption that committees will enhance **board effectiveness** and corporate transparency. Questions remain, however, around the extent to which this is really the case and around the risk that committee structures might fragment and diminish the responsibilities of the board as a whole.

International developments over the past year have put a major emphasis on **audit committees**, giving them responsibilities for ensuring integrity in financial reporting. Audit committees generally appoint and oversee the work of external auditors, and supervise internal control and reporting functions. The Australian Principles call for a minimum of three members, with a majority of independents and a chair who is not board chair (audit committee requirements are mandatory for the top 200 companies on the ASX). The revised UK Code favours the same composition and prescribes the role of audit committees in detail. The Sarbanes Oxley Act mandates the formation and powers of audit committees: in the US, all members must be independent and at least one certified as a “financial expert”.

In New Zealand the IOD has put a focus on the work of audit committees. NZX proposals would make audit committees a mandatory listing rule requirement (with majority independent director membership). There is ongoing debate over whether board and audit committee chairs should always be separated and the level at which the chief executive (and chief financial officer) should take part in audit committee processes.

There is a focus on other committees in areas of particular complexity and/or sensitivity, **remuneration and board nominations** in particular.

The Australian Principles and UK Code favour such committees, in each case with a minimum of three members and a majority of independents. Remuneration committees are intended to set the framework for board remuneration, recommend policy on issues like incentive schemes and settle executive packages. Nomination committees recognise the importance of selecting prospective directors for shareholder voting (and perhaps having to terminate the tenure of others). There has been intense debate in the UK over whether a board chair should also chair a nominations committee (with this now permitted in the revised UK Code). The Australian Principles recommend all committees have formal, disclosed charters and annual reporting on the work of these committees.

The NZX proposed Code includes remuneration and nomination committees along the lines of those recommended in Australia and the UK.

Refer Questionnaire pages 9-10

Issue Four: Reporting and Disclosure

Reporting and disclosure are fundamental in all Corporate Governance. For shareholders and others to be informed participants, they must receive comprehensive financial reports and have access to other information. Good governance requires these reports to have **integrity**, and disclosure to **be timely and balanced**. Moreover, it is widely accepted that good governance requires good reporting on the policies and practices of governance itself – and indeed, such reporting becomes fundamental in the context of a “principles-based” approach to governance.

There is a major focus internationally on ensuring integrity in financial reporting through audit committee structures and strengthened management accountability. The Sarbanes Oxley Act requires that CEOs and CFOs certify their financial reports to the Securities & Exchange Commission (with criminal penalties for violation). The Australian Principles call for the CEO and CFO to make a written declaration to the board that accounts are “true and fair”. Such **certification** – external or internal to the entity – is seen as an obvious step to reinforce accountability and to balance the formal signoff requirements generally in place for directors and auditors.

Credible accounting standards also contribute to integrity in financial reporting. New Zealand plans to adopt international accounting standards issued by the Accounting Standards Review Board from 1 January 2007 (or 2005 in the case of dual-listed companies). Other countries are moving in the same direction (Australia in 2005 for all companies). Accounting standards issues are beyond the current consultation process.

There is a view that public company quarterly **financial reporting** is good for governance: shareholders are kept more informed on performance and changes in performance are less likely to deliver shocks to the market. Quarterly reporting is required on some US markets. However in New Zealand some people consider that continuous disclosure practices achieve the same ends and make quarterly reporting unnecessary.

New Zealand has had a legislatively based **continuous disclosure** regime since changes in the law in December 2002. Listed companies must immediately release material information about themselves to the NZX unless there are particular reasons to maintain confidentiality. The requirement strengthens timely and balanced disclosure for keeping shareholders and the market informed. There may be additional steps that would improve disclosure policies and practices in the New Zealand context. These considerations may apply in particular to non-listed entities, which operate beyond current requirements for continuous disclosure.

As stated above, **governance policies and practices** may be a special feature of reporting and disclosure. The UK Code calls on companies to report annually on how they apply principles in the code – and where they have not been applied, to explain why. The Australian Principles adopt a similar approach, providing detailed guidelines on information that should be included in the Corporate Governance section of the annual report. The entity’s standing policies and procedures for governance, it is recommended, should also be published on websites for public access at any time. Under this perspective, the level of compliance with – and departure from – the codes and principles is made transparent so that shareholders and others can form their own judgements and hold boards accountable. Code compliance is voluntary but the marketplace has a framework for rewarding or penalising companies over their governance policies and practices.

Refer Questionnaire pages 11-12

Issue Five: Remuneration

Remuneration is a critical consideration in attracting, retaining and motivating directors and executives. In addition, remuneration policies and structures determine how the financial risks and rewards arising from business performance are shared between directors, executives and shareholders.

Many issues arise over incentives and rewards in remuneration. In New Zealand, there is debate over the **level of directors' remuneration** both in general and in respect of particular entities. The debate may focus on the substantial commitment and responsibilities expected of directors or on dissatisfaction with the performance record of boards.

The Australian Principles favour entities forming their own clearly defined **links between remuneration and performance**, and disclosing relevant policies and processes. Under this view, well-informed shareholders can make their own judgements on whether remuneration levels and composition are appropriate to the needs and circumstances of the particular business. The Australian Principles note that lack of clarity over how remuneration is set exacerbates debate about its appropriateness. New Zealand and Australia have established requirements for annual report disclosure on the levels of directors' and senior managers' remuneration, although not associated policies and processes.

The performance link may involve components of remuneration "at risk", or received only if and when certain objectives (profit growth, targeted operational outcomes and so on) are achieved in the future. There is debate over the appropriate proportion of "at risk" remuneration to total remuneration, and wide diversity in the design of these performance linkages. The issues are complex and appropriate structures vary widely across business types and sizes. The view of the Australian Principles is that the complexities facing each entity require the focus of a specialist remuneration committee.

There is debate over **share options** as one form of "at risk" remuneration, where directors and employees take on the same incentives and rewards as shareholders. Options have been much favoured in the United States over the past decade. In Australia, the Investment and Financial Services Association has detailed guidance on executive option schemes. The Australian Principles take a view that options should form no part of non-executive directors' remuneration. The UK Code takes the same view but with exceptions permissible subject to shareholder approval in each case. NZX proposals favour directors taking a portion of their remuneration under a performance-based equity compensation plan. There is diversity of opinion on the appropriateness of options and also on associated questions of financial accounting. In the US, there is major debate on whether options issued to directors and executives should be expensed in the entity's profit and loss statement.

Continued over

Remuneration may be effectively linked to performance but will the entity really benefit over the long term? Commentators point out a risk that, where rewards are achievable in the short term, directors and executives may tend to ignore their and shareholders' longer term interests. This "short termism" may be a concern in the composition of remuneration and the design of particular incentive structures.

When directors retire, it may be appropriate to recognise the value of their service through special **retirement payments**. This may be part of superannuation for executive directors or some deferred performance component of remuneration for non-executive directors. The Australian Principles take the view that the latter should not receive retirement benefits other than statutory superannuation.

Obviously, shareholders and others have a substantial interest in all aspects of remuneration. In New Zealand, shareholders at annual company meetings must approve the total of board remuneration each year. In some circumstances, it might be appropriate for **shareholders to be direct approvers** of executive remuneration policies and/or packages.

Refer Questionnaire pages 13-14

Issue Six: Risk Management

Boards must ensure that risk in all its forms is identified and managed. There is increasing recognition that the policies and processes required for this are central to Corporate Governance. Moreover, sound risk management is a basic prerequisite for integrity in financial reporting.

It might be argued that the biggest risk facing any entity is failure in the governance structures themselves. Under this view, the allocation of clearly understood responsibilities to the board and management becomes especially important. The Australian Principles recommend entities develop their own charters setting out the responsibilities and delegations of the board. Much of the debate on board effectiveness highlights the need for timely and balanced reporting by management, and the importance of questioning directors who keep themselves informed from many sources.

The Australian Principles also call for formal **policies and processes** for risk management, with the CEO and CFO making written declarations to the board on compliance with these. There are many related questions around disclosure of policies, processes and outcomes particularly in commercially sensitive areas of risk. The UK Code calls for boards to annually review their company's internal control systems and include references to this in their annual report to shareholders. In the US, Sarbanes Oxley requires management to report annually to the SEC on internal control structures and procedures.

Refer Questionnaire page 15

Issue Seven: Auditors*

Auditors must be independent and well informed. Good governance requires close attention to an array of factors that might compromise independence or otherwise reduce effectiveness. These factors include the risk that objectivity is lost as the auditor-client relationship develops, emergence of possible commercial conflicts and limitations on auditors' access to information and different points of view.

Much of the debate focuses on whether, and how often, entities should change their auditors – questions of **rotation**. The Sarbanes Oxley Act requires rotation of lead audit partners and review partners every five years. In Australia, CLERP 9 introduces that same requirement. In New Zealand, ICANZ has proposed rotation of lead audit partners after seven years. There is ongoing debate on the possible extension of rotation rules to **audit firms**, with some arguing that audit partner change is sufficient.

Large accounting firms provide audit and **other/non-audit services** to entities, raising issues of possible conflict. The Sarbanes Oxley Act prohibits firms from providing non-audit services unless they are of a certain type and in each case, approved by the audit committee. Overall the Act puts a 5% cap on fees that can be earned by an audit firm from providing non-audit services to the same client. CLERP 9 proposes nine categories of non-audit services in which audit committees must give approval and make an annual declaration that no breach of audit independence resulted. The Australian approach will include annual reporting of fees in each category. The UK Code relies also on audit committees to scrutinise non-audit work and confirm in annual reports that independent has not been breached. In New Zealand, NZX Code proposals favour auditors not performing non-audit work for publicly listed companies.

Other issues arise over the possible advantages of giving access to auditors to employees or others with valid concerns or information that might aid the auditing process – the issue of **"whistle-blowing**". Some commentators suggest employees should have some access to audit committees and/or to auditors, outside an entity's formal accountability system. CLERP 9 in Australia, for instance, proposes legal protection against retaliation for employees who go to regulators with information in good faith.

The Protected Disclosures Act 2000 allows employees of New Zealand organisations to disclose information about serious wrongdoing in or by that organisation in certain circumstances.

Governance debate around the world has put a spotlight also on the regulation and **oversight of auditors** themselves. In Australia, CLERP 9 proposals will extend the role of the Financial Reporting Council to oversee auditor independence. In the US, Sarbanes Oxley establishes a five member board, independent of the profession, to set auditing standards. In the UK, the Auditing Practices Board has been given new responsibilities to set relevant accounting standards. There is scope for debate in New Zealand on the merits of new structures in this regard.

Refer Questionnaire pages 16-17

Issue Eight: Shareholder Relations

Some commentators have focussed on the contribution that well-informed shareholders make to good governance.

Relations between entities and their shareholders or owners must be cooperative and mutually responsive. This obviously depends largely on the effectiveness of communication between them. Various governance issues arise, therefore, around the content, timeliness and processes of communication.

There is a trend towards making entities more responsible for shareholders' understanding of strategy, performance and other matters including governance. This is reflected, for instance, in Australian CLERP 9 proposals for easier communication processes. Legal barriers to companies emailing annual reports and other documents will be removed, while they will also be required to publish questions from shareholders on their websites.

Some have challenged whether, particularly in markets where institutional investors make up a significant part of the market, they should have actual voting responsibilities.

The UK Code, for example, puts special emphasis on dialogue and "mutual understanding of objectives" between companies and their institutional shareholders. The Code calls, for instance, for the board chair to have discussions with these shareholders on governance and strategy. Moreover, it holds that institutions have a responsibility to make "considered use" of their votes and disclose their voting behaviour to their own members on request. Shareholder obligations, including possible **voting obligations on institutional shareholders**, are an area of debate.

There is an increasing focus on ensuring effective communication and shareholder participation at **annual meetings**. For instance, the UK Code promotes opportunities for shareholders to question board committee chairs. In the UK and Australia, companies are now encouraged to facilitate access for shareholders to the auditors at annual meetings (New Zealand has long required auditors to at least attend meetings).

Shareholders who are well informed are more likely to engage with the company. The Australian Principles call on entities to design and disclose their policies and **strategies on communication itself**. This should, it reasons, encourage shareholders to access information, ask questions and participate at meetings.

Much of the thinking on communication is directed at public listed companies, but there are important questions around the quality and timeliness of reporting and disclosure by other forms of entity.

Refer Questionnaire pages 18-19

Issue Nine: Stakeholder Interests

Stakeholder interests (beyond those of shareholders) have entered debate on Corporate Governance largely through recognition that creditors, suppliers, employees and others can also be major contributors to business success, and be exposed in the event of corporate failure. Concepts of "social accountability" have also gained traction in some countries.

The OECD governance principles put a particular focus on **stakeholder interests**, calling for "active cooperation" between entities and their stakeholders. The OECD does, however, accord more prominence to the interests and rights of shareholders and notes that cooperation with stakeholders will reflect the laws and customs of each country. Under this view, governance policies and practices specific to stakeholders should not mean rolling back shareholder rights or creating new rights for stakeholders. The Australian Principles call for entities to recognise the legitimate interests of stakeholders – this is best done by ensuring legal and self-adopted obligations toward employees, consumers and others are built into a board and management code of conduct (see Issue One).

There is potentially wide scope for debate over how stakeholder interests **are represented at board level** and the extent to which such representation should be addressed through governance policies and processes.

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24 September 2003

Dear Reader,

CORPORATE GOVERNANCE IN NEW ZEALAND – CONSULTATION ON ISSUES AND PRINCIPLES

Recently we sent you the Questionnaire and Background Reference, entitled "*Corporate Governance in New Zealand – Consultation on Issues and Principles*".

On page 17 of the Background Reference we summarise corporate governance issues and developments regarding auditors. This letter is to clarify two aspects of this summary.

The third paragraph discusses issues of possible conflict arising when auditors provide non-audit services. This refers to the United States Sarbanes Oxley Act, and states that the Act puts a 5% cap on fees that can be earned by an audit firm from providing non-audit services to the same client. In fact, the Act does not impose a cap. The Act contains a number of measures that aim to ensure that auditor independence is not compromised by the provision of non-audit services. These are quite complex. Generally audit committee approval is required for the provision of non-audit services.

We also refer to NZX's draft corporate governance rules and Corporate Governance Best Practice Code. The draft Code that was available when our paper was prepared said that auditors should not provide non-audit services. The final version replaces this by expanding on NZX's expectations of boards regarding the relationship between issuers and auditors. It encourages boards to establish frameworks for this relationship, to ensure that the independence of auditors is not impaired, and to address what, if any, non-audit services may be provided by auditors to the issuer.

Pages 7 and 8 of the Background Reference contain references for readers wanting more information on any of the topics in our consultation, including the Sarbanes Oxley Act and the NZX corporate governance proposals.

Liam Mason
General Counsel

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